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October 26th EU Summit decided on a broader policy framework to address the euro area debt crisis: Implications for Greece and the euro area

Contents

Part I - October 26 EU Summit statement: Key components and assessment

The outcome of the October 26th EU Council contained few surprises, coming broadly in line with various draft Summit statements leaked to the press in recent days. An agreement on a number of important components and operating modalities of the new framework is probably some way off. Yet, EU leaders admittedly made further progress towards addressing the inner sources of the lingering crisis, triggering a rally in global equity markets and helping the single currency to outperform its major currency peers. In more detail, the broad framework agreed at the Summit centers on the following elements:

Boosting the EFSF's lending capacity

EU leaders endorsed the two main options for boosting the mechanism's firepower that were tentatively agreed at the October 22 Ecofin; namely (**i**) an insurance scheme and (**ii**) a special purpose investment vehicles (SPIV) open to potential funding from the IMF as well as public and private financial institutions and investors. The Summit statement provided only broad guidelines as to the operating modalities of the two structures. Important parameters of the agreed leveraging schemes (related to *e.g.* the extent and cost of insurance) are not expected to be finalized before the November 6-7 Eurogroup. Moreover, no concrete commitments by potential investors to the proposed SPIV were announced. The upcoming G20 meeting on November 3rd may provide some clarity on the latter issue.

Despite the lack of concrete details, the Summit statement read that the EFSF will be leveraged "up to four or five times". Currently, the mechanism's effective lending capacity is €440bn. Out of this amount, some €48.5bn have already been committed for the Irish and Portuguese rescue programs (€22.5bn and €26bn, respectively). An additional €100bn has been also earmarked for a second bailout plan for Greece, along with some €30bn in the form of euro area member state contributions to a new PSI package. As to potential financing of the proposed SPIV by private and public financial institutions and investors, the French President is reportedly planning to speak to his Chinese counterpart Hu Jintao later this week to encourage investments in the fund.

The first agreed option for leveraging the EFSF involves allowing the mechanism to act as a bond insurer. Specifically, rather than issuing bonds and then lending to sovereigns and banks, the EFSF would instead be allowed to guarantee the "first-loss" of newly issued European sovereign bonds - say, up to a level of 20% or 30%, as per a number of recent reports -, in the event of a default or a debt restructuring. This option does not currently apply to euro zone states already receiving EU/IMF financial support as they are no longer tapping the primary market.

Although there appeared to be some disadvantages in the aforementioned proposal, certain merits deserve special attention. Among others, under this plan the EFSF would not require a change in its framework agreement and, therefore, there is no need for a new round of *potentially* long parliamentary ratification procedures. Separately, the EFSF would have the additional flexibility of determining the degree of leverage provided on a case-by-case basis, depending on which country's debt is being guaranteed, the duration of the specific bond issue and prevailing market conditions.

The second proposal, which could run in parallel with the first one, involves the establishment of special purpose investment vehicles (SPIV) by the EFSF which could seek funds from other (official and/or private) sources, including the IMF. Apparently, sovereign wealth funds and non-EU countries including large surplus emerging economies would be allowed to participate. This would enlarge the amount of resources available to extend loans, for bank recapitalization and for buying bonds in the primary and secondary markets. Yet, press reports suggested that some EU officials are reluctant to give non-EU states such as China more say in the euro area's future. For their part, donor countries could possibly request the proposed SPIV to have preferred creditor status. Reuters also reported that China, in exchange for its support, would request to be classified as a "market economy' by the World Trade Organization (WTO) before 2016, which would make it more difficult to impose against it "anti dumping" and "safeguard" measures.

EU-wide bank recapitalization

EU leaders agreed on a two-pronged plan to make European banks more resilient to the spiraling sovereign debt crisis; namely: **(i)** increase their capital base, and **(ii)** ensure European banks have adequate medium-term funding. On the issue of recapitalization, the EU Summit statement read that banks will be required to achieve a core tier-1 capital ratio of 9% (vs. 5% in the summer EBA stress tests) after marking down to market their EMU-periphery sovereign bond holdings as per September 30, 2011. The deadline to reach the new core tier 1 threshold is end-June, 2012. To achieve this, banks should first be required to raise capital via the private sector. Any remaining shortfalls have to be met by national governments. The EFSF would be used only as a last resort. Specifically, if sovereign support is not available, the EFSF could then fund the recapitalization via a loan in the case of Eurozone countries.

However, there are questions over whether banks would be able to raise funds independently. Under current market conditions, European banks could face increased difficulties in executing a successful share issue to shore up capital, as bank stocks have come under intensive pressure in recent months on the back of heightened contagion fears. Banks could also face difficulties in selling assets in the current gloomy environment without suffering significant losses. Another concern is how banks can reach the higher capital threshold without starving the real economy from credit, putting further pressure on Europe's faltering economy. The ability of European governments to shoulder the burden of raising capital for banks is another strenuous matter as it could put additional pressure on overstretched sovereign fiscal positions. The issue over whether a government bailout for banks would be instrumented via the use of preferred shares (as was the case in the US with the Term Asset-Backed Securities Loan Facility at the height of the crisis in 2008) or via common shares, is a furthermore potential area of division between the official sector and international bankers.

The Summit statement did not specify the exact amount needed for recapitalizing banks. Yet, the European Banking Authority (EBA) said last week that the total EU-wide capital shortfall is preliminarily estimated at €106.5bn, based on a recent review of a sample of 70 EU banks. This estimate falls well short of initial market expectations for a total shortfall of between €200bn and €250bn as well as the €200bn figure presented in the IMF's latest (Sept 2011) Global Financial Stability Report. The EBA noted that a final estimate will be provided next month, based on the end-September bank balance sheet figures.

As regards the issue of securing medium-term funding, the Summit statement lacked concrete details. Instead, it argued that "a simple repetition of the 2008 experience with full national discretion in the setting-up of liquidity schemes may not provide a satisfactory solution under current market conditions", adding that "a truly coordinated approach at EU-level is needed". Specific details on this issue will probably not be finalized before the upcoming Eurogroup in early November. Meanwhile, the ECB continues to provide crucial short- and medium-term funding to the banking sector. After conducting a full allotment of 12-month duration

LTRO (long term refinancing operation) earlier this week, the ECB will offer a 13-month LTRO tender in mid-December. Following its decision at the October policy meeting, there will also be full allotment tenders of 3-month MRO (main refinancing operations) until at least mid-2012 while, as of next month, the ECB will resume a new €400bn covered bond purchasing programme that will remain in place until October 2012.

Italy commits on strengthened fiscal consolidation plan

The October 26d Summit statement noted that without a decisive commitment on fiscal consolidation and structural reforms from euro area sovereigns –especially those experiencing tensions in sovereign debt markets- any comprehensive plan aiming to resolve the debt crisis would be insufficient. After intensive pear pressure at the previous EU Summit, Prime Minister Berlusconi presented last Wednesday a "letter of intent" to EU, outlining his government's commitment to radical structural reforms aiming to boost Italy's potential growth and restore market confidence towards public finances. Reportedly, the letter to the EU heads of state and government included, among other, labour market reforms, a privatization plan to generate €15bn in next three years, constitutional amendments, and plans to liberalize closed professions. A rise in the retirement age to 67 for both men and women from 65 currently by 2026, one of the key reforms EU officials had demanded, was also included in the package submitted. Yet, certain market doubts remain over the Italian government's commitment to the implementation of the proposed reforms, especially given increased domestic political jitters. Media reports in Italy suggested that, in return for securing approval on pension reform from Umberto Bossi- the leader of the junior coalition party Northern League - Prime Minister Berlusconi agreed to resign from the office and open the way for snap elections as early as March 2012.

Tentative progress on tighter economic and fiscal governance in the euro area

In an effort to prevent a future economic crisis, the October 26th Summit announced steps towards tighter economic governance. Among the measures put in place, European Union deficit and debt rules should be embedded in national legislation, preferably at constitutional level by the end of next year, while national budgets "should be based on independent growth forecasts". Particularly emphasis was placed on the need the European Commission to get more powers in monitoring closely national budgets to better coordinate macroeconomic policies across the euro area. Other recommended measures included proposals for limited Treaty revisions which would speed up the process of moving towards closer economic governance, particularly on fiscal issues. In a post-Summit press conference, EU President Van Rompuy vowed to present, in cooperation with the European Commission and Eurogroup heads, an interim report on governance reforms and deeper fiscal integration in December "including the possibility of limited Treaty changes". The report is expected to be finalized by March 2012.

Part II - New bailout plan for Greece: Implications for debt dynamics and the domestic economy

The main parameters of the new bailout plan for Greece announced at the October 26th EU Summit are as follows:

— **new EU-IMF programme financing up to €100bn until 2014;**

— **euro area member state contributions of up to €30bn for a new, enhanced and voluntary PSI package for Greece; and**

— **provision of credit enhancements to underpin the quality of collateral so as to allow its continued use for access to Eurosystem liquidity operations by Greek banks.**

As per the EU Summit's statement, a 50% nominal discount will be applied on notional Greek debt held by private-sector investors with an objective to reduce Greece's public debt-to-GDP ratio to 120% by 2020. The new programme will be accompanied by a strengthening of the mechanisms for the monitoring of implementation of reforms, though its execution will remain a responsibility of the domestic authorities.

To that aim, the Commission, in cooperation with the other Troika partners, will establish for the duration of the programme a "monitoring capacity" on the ground, including with the involvement of national experts. This monitoring mechanism will be working in close cooperation with the Greek government and the Troika, providing advise and assistance with an aim to facilitate the rigorous implementation of the agreed reforms agenda.

The governance of the Hellenic Financial Stability Fund will also be strengthened in an effort to ensure the efficient use of programme funding for the recapitalization of Greek banks. Furthermore, a special Task Force set up by the Commission to provide technical assistance to the government in issues related to the efficient absorption of structural EU funds will remain on the ground, with a number of recent reports speculating over its future monitoring role for domestic fiscal and structural policies.

New bailout plan for Greece: Assessment and implications

Based on our reading of the October 26th EU Council statement we provide below some further analysis on the main components and potential implications of the newly announced bailout plan for Greece. *As an important disclaimer, we emphasize that our analysis is only preliminary as many important facets and operating modalities of the new package remain unknown. We will revisit the subject, offering additional estimates and possible revisions, once more clarity is provided by euro area authorities on a number of important issues and ongoing negotiations between and the official sector and private investors on the new PSI deal reach a more mature stage.*

Up to €172bn of EU-IMF programme financing committed so far, consisting of:

— up to €100bn in new EFSF - and, potentially, IMF - loans until 2014;

— up to €30bn of EZ member state contributions for a new (voluntary) PSI package; and

— €42bn of still undisbursed funds under the existing Greek Loan Facility.

The July 21st EU Council announcements will apply as regards the improved terms and conditions of the new & existing EZ/EFSF loans, related to e.g. interest rate charges, grace periods and loan maturities.

Additional State financing via an enhanced PSI scheme

As per the October 26th EU Summit statement, the new PSI plan should (i) be accepted by bondholders on a voluntary basis, (ii) involve a 50% nominal discount of notional Greek debt held by private investors, and (iii) facilitate a decline of the Greek debt ratio towards 120% by 2020. That is, assuming that a set of relevant fiscal and macroeconomic variables evolve in line with the latest EC/IMF/ECB baseline projections (Greece: Debt Sustainability Analysis, October 21, 2011). In keeping with the Summit statement, the new bailout programme should be agreed by the end of 2011 and the exchange of bonds should be implemented at the beginning of 2012.

According to a number of recent press reports, the new plan (dubbed hereafter as PSI-plus) will likely cover the entire universe of privately-held Greek government debt, with a total outstanding amount of ca €205bn and maturities extending up to 2035 (see Table 1). As a reminder, the initial PSI scheme involved government paper maturing up to 2020, with the corresponding notional of eligible bonds estimated at ca €150bn. Based on the eligibility requirements of the initial PSI scheme (July 21, 2011), the total amount of gross financing provided to Greece under the new PSI-plus proposal will be at least:

— €60bn until August 2014;

— €150bn until 2020; and

— €205bn until 2035.

That is, assuming full private-sector participation and without incorporating the cost of any "sweeteners" for encouraging the voluntary involvement of private bondholders. Note that the additional financing to Greece provided by the new PSI deal will mainly take the form of deferred debt amortizations after the bond exchanges and, to a lesser extent, lower annual interest

Table 1– Estimated breakdown of Greek public debt by type of holder (in EURbn)

A. PSI-plus eligible debt	
Greek banks	47
Greek pension funds	23
Foreign accounts	137
Total PSI eligible debt	**207**
B. Non PSI eligible debt	
ECB holdings	55
T-bills	16
Troika loans	65
Other debt (*)	17
Total non PSI eligible debt	**153**
Total Greek government debt (A+B)	**360**

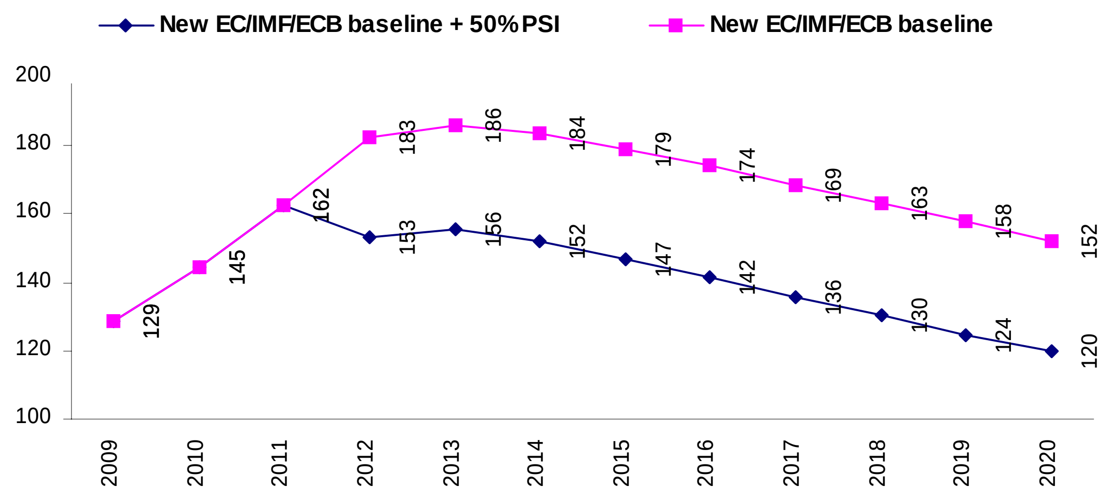
Source: Greek MoF, IMF, Eurobank EFG Research estimates

(*) Incluses e.g. loans to Greek public enterprices (~€10bn), Titlos (~€5.4bn) etc.

Impact on debt sustainability and the evolution of the State borrowing requirement

Assuming full (i.e., 100%) participation of private sector bondholders, the PSI-plus scheme provides an immediate gross debt relief of around €100bn (~47ppt-of-GDP) vs. an estimated upfront debt reduction of ca €26.1bn in the initial PSI proposal (i.e., from both the bond exchange scheme and debt buybacks). The new scheme also appears to be in line with the "50% PSI" scenario presented in the Troika's latest debt sustainability analysis (Oct. 2011). Under that proposal (and assuming that all relevant macroeconomic & fiscal variables evolve in line with the new EC/IMF/ECB baseline scenario) the debt ratio falls towards 120ppt-of-GDP by the end of 2020 (Table 2).

Table 2– Projected evolution of Greek public debt ratio net of collateral required for PSI (ppt-of-GDP)



Source: Eurobank EFG Research forecasts based on latest EC/IMF/ECB projections

Besides the significant up-front debt relief provided by the newly announced bailout package for Greece, the new plan also aims to provide full coverage of the government borrowing requirement until 2014 and also finance a significant part of the projected cumulative borrowing need until 2020 (see Table 3). As assumed in the revised baseline scenario of the latest troika report on Greece's public debt sustainability, the sovereign borrower is unlikely to resume access to market financing before 2021. This compares with earlier forecasts for a gradual return to sovereign debt markets from 2014 onwards. Note that the 4th IMF program review assumed that Greece would be able to return to funding markets in 2014, raising as much as €11.4bn that year via the issuance of medium- & long-term debt securities.

Taken at face value (and from a pure debt-sustainability standpoint), the new bailout plan for Greece appears to constitute an improvement relative to that announced at the July 21 EU Council. Yet, a number of important challenges and risks remain with respect to its implementation. A more throughout assessment of these uncertainties could not be possible at this stage, given that important parts and modalities of the new package still remain unknown. The deployment of such risks will potentially be a function of, among others, the final structure of the new PSI scheme, its implications for domestic banks and social security funds, the reaction of rating agencies and the evolution of the domestic economy and sociopolitical environment in the subsequent period.

Table 3– Projected gross borrowing need financing source in EURbn (period: 2012-14)

1. Gross borrowing need (A1+A2+A3+A4+A5)	**252.6**
A1. General government budget balance	**34.4**
A2. Amortizations (B1+B2+B3)	**125.2**
B1. MLT debt held by private-sector creditors & the ECB (b1+b2)	**97.1**
b1. Residents	34.8
b2. Non-residents	62.3
B2. ST debt (c1+c2)	**18.6**
c1. Residents	14.9
c2. Non-residents	3.7
B3. Official creditors (d1+d2)	**9.5**
d1. IMF	9.5
d2. EU	0.0
A3 Recognition of implicit/contingent liabilities	**27.8**
A4. Other *(* **bank recap, deposit buffer etc.)**	**35.2**
A5. PSI "sweeteners"	**30.0**
2. Gross financing source (C1+C2)	**30.6**
C1. Privatization receipts *(includes proceeds from sale of assets linked to bank recap.)*	**12.0**
C2. Market access (e1+e2)	**18.6**
e1. MLT debt	0.0
e2. ST debt	18.6
Financing gap (1.-2.)	**222.0**

Available funding from official sources & PSI (C4+C5+C6+C7)	**222.0**
C4. Offical financing already commited from 1st EU/IMF program (z1+z2)	**29**
z1. IMF (3/11 share)	7.9
z2. EU (8/11 share)	21.1
C5. EZ contributions to PSI-plus package	**30**
C6. New official financing (EFSF/IMF)	**100**
C7. PSI financing	**63**

Source: Eurobank EFG Research forecasts based on EC/IMF/ECB projections

(*) The table above assumes disbursement of the two next EU/IMF loan tranches (€8bn and €5bn, respectively by end-2011.

As to the approval of the new bailout deal by the Greek Parliament, local press reports suggested over the last couple of days that the government may insist on a strengthen majority of 180 in-favor votes. Note that the leading Socialist party, Pasok, currently controls a slim majority of 153 deputies in the 300-seat parliament, with some recent opinion polls showing that it is lagging the main opposition party, ND, by 7ppts or more. Yet, no party would be able to form a single party government if elections were to happen today.

With the government currently facing an increasingly disillusioned voter base and militant trade unions, several Pasok MPs have already signaled their unwillingness to follow party lines in voting in favor of new austerity measures. A number of them have even called for the formation of a "national salvation" government to deal with the current situation. According to the local press, finance minister and vice premier, Evaggelos Venizelos, informed opposition leaders earlier this week that the government may ask for a strengthened majority of 180 in-favor votes in an upcoming parliamentary vote on the MoU of the new bailout package. Yet, a number of reports have indicated that the troika of official lenders is strongly against such an option, with the government's final decision on the issue remaining unclear at this point.

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